

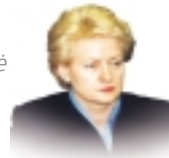
# FISCAL POLICY REFORM



USAID advisors on taxes were extremely useful, and I only regret that the time of our cooperation is coming come to an end. The advice and information that the Ministry received through USAID improved our professionalism and was highly beneficial.



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USAID was one of the first donor organizations that came to Lithuania. I had the honor to witness this process, and our cooperation has strengthened through the years. The Agency has provided essential support for the development of democracy, business, finance, and other vital areas. I am happy that USAID has accomplished its mission in Lithuania, and I would like to thank USAID for all the assistance and support we received during this difficult transitional period.

Independence brought rapid and immense changes to Lithuania's public finance system. Fiscal management appropriate to a market environment was introduced. Tax reform completely reshaped the composition of budget revenues. Expenditure structures have been gradually transformed as fiscal responsibilities between the government and enterprises have been redefined. Debt management has emerged as a new discipline in public finances.

Tax reform has been driven by two basic policy objectives: to stimulate formation of a market economy and to prepare for European Union (EU) accession. In the beginning of the transition process, government revenues fell as a greater share of economic activity shifted to the (untaxed) private sector and to the "hidden" economy. To reverse these tendencies, budget revenues were restructured by replacing direct and indirect taxes. This included the introduction of a general turnover tax, followed by the introduction of VAT and a small set of excise taxes. Direct taxes were also reformed.

By some estimates, the shadow economy reached 40 percent of total economic activity during the 1990s. This created an urgent need to improve the tax administration system and to widen the tax base. In 1995, the Central Tax office was established in accordance with EU requirements. This was perhaps the most important step in separating tax policy and tax administration. The State Tax Inspectorate and Customs Department then implemented a number of management reforms aimed at reducing the number of local offices, to simplify operations.

At the time of independence there was one unified state budget for all governmental units in Lithuania. The new Constitution defined the content of both state and municipal budgets. However, it did not limit the overall role of the Government regarding the state and municipal budget. The lack of a legal limit on fiscal activity contributed to rapid growth of extra-budgetary funds. By 1998, extra-budgetary accounts increased from 4 to 30. Those funds were not subject to regular parliamentary scrutiny, and the resources devoted to the funds reduce fiscal flexibility. A decision was taken in 1999 to consolidate the accounts of all extra-budgetary funds into one account, to improve budget transparency and over-sight.

In 1999, the Government approved a budget reform strategy and prepared a new Budget Law. The new process includes a three-year budget planning cycle, adoption of performance and program based budgeting methodology, and better expenditure analysis and control. All these measures should make expenditures more efficient and more accountable to the public.

In 1994, 65 percent of the central government debt was financed by issuing domestic Treasury bills. As Lithuania became more creditworthy on the international capital markets, the Government shifted its debt management strategy to rely more on foreign borrowing. A total of \$60 million was borrowed through private Eurobond placements in 1995, \$200 million in 1997, and \$182 million in 1999. Domestic financing for the Government continues to be constrained by Lithuania's low savings rate and consequently the limited capacity of the domestic financial market

At the end of 1998, the Government approved a medium-term borrowing policy, which required that short-term debt not exceed 25 percent of total state debt, and that state foreign debt not exceed 85 percent of total debt. The policy also requires that state expenditures for interest on state debt not exceed 15 percent of all budget revenue. By ensuring that state borrowing is not excessive, debt limits help establish Lithuania's credibility on the international financial markets.

## Discrete USAID assistance activities within the Fiscal Sector have included:

- **Tax System:** Since 1994, USAID has supported programs in the fiscal sector to rationalize the tax system and broaden the tax base. USAID helped prepare new laws on personal income and enterprise income taxation, which were approved in 1996. Those laws created a clearer definition of income, reduced the number of exemptions, and unified the rates for corporate and personal income tax. This resulted in greater tax equity.
- **Tax Policy:** Complementary efforts to support a more comprehensive restructuring of the tax system were implemented by the Harvard Institute for International Development (HIID) under a new tax policy project begun in 1997. The project focused on simplifying tax laws, making them more coherent, broadening the tax base, lowering and simplifying tax rates, encouraging fairness and neutrality in taxation, and informing tax policy decision-makers about measures adopted in Western countries. In addition, it strengthened the Ministry of Finance's capacity to analyze and assess alternative tax policies, using economic modeling techniques. Assistance to the Ministry of Finance resulted in simplifying and lowering rates and broadening the base of the personal income tax. It also ensured that the revised VAT laws were in harmony with EU standards, that new tax legislation covered real property, and that the framework for a unified Tax Code was laid.
- **Tax modeling:** Tax modeling assistance for the Ministry of Finance advanced its capabilities to craft tax policies and more accurately estimate the effects of these changes on Government revenues. HIID experts helped integrate a microeconomic model for measuring the projected impact on revenues of proposed changes in the personal income tax. This personal income tax model is a micro-simulation of the effects of changes in tax policy on revenues. The model was used to assess the impact of various changes in direct taxation, to ensure that such changes would have a positive effect on distribution, while not exacerbating macroeconomic imbalances. The model was also used to assess the impact of modifying the national pension legislation by introducing a multi-tier pension system. The Ministry has been shown how to update the model so that the accomplishments under this project are sustainable. The Ministry staff is developing a variety of similar models for other taxes.
- **Fiscal Policy:** Assistance to the Ministry of Finance was also provided in the fiscal policy area. USAID helped develop short term forecasting models, a policy simulation model, and a medium-term (3 year) macroeconomic model. Also, a series of policy notes on a wide range of fiscal and macroeconomic challenges formed the core for several of the major reforms that were adopted to combat fiscal stress. In addition, USAID provided assistance on macroeconomic reporting and analysis. Jointly building and utilizing the models with the Ministry of Finance staff has ensured that the models can be operated appropriately and will be maintained and improved over time. This allows the Government to more accurately forecast the effects of macroeconomic and revenue policy changes on fiscal and economic performance. USAID financed training opportunities for the Ministry of Finance staff to analyze linkages between fiscal policy, structural policy, and macroeconomic vulnerability, enabling the Ministry to better predict and respond effectively to fiscal sector developments. A modern set of revenue and expenditure instruments have been introduced; debt management capabilities have evolved and, most importantly, fiscal stability has been achieved.

■ Public debt management seminar, August 1999

■ Director of the Ministry of Finance Fiscal Policy Department Rimantas Vaicenavičius and Head of Planning and Analysis Division Dzintra Sakevičienė discuss fiscal policy issues





USAID provided methodological support to create and develop the treasury, consulted on budget management and reform, fiscal management, debt management and other areas. Through the USAID program, the Ministry staff not only improved their qualifications, but also received support in developing training capacity within the Ministry. Another important activity was the assistance of USAID advisors in drafting legislation in the aforesaid areas. The Ministry of Finance is grateful for the professional support, good will and flexibility extended by the USAID program management, staff and experts.



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Effectively targeted at institution building, USAID assistance comprised nearly half of total help that Lithuania received over a decade of transition in the most difficult areas of economic and financial management. Aimed at strategic economic issues, the USAID assistance filled in the gaps of transition in establishing the country's important economic strategies.

- **Tax Administration:** A concerted effort has also been made to improve tax compliance. The U.S. Treasury's tax administration project focused on increasing tax collectors' skills, through a series of seminars on tax collection techniques, indirect methods of audit, criminal investigation, taxpayer services, and other topics. Another activity, the "train-the-trainers" program, aimed at developing human resources following completion of the U.S. Treasury program. A notable accomplishment was the reorganization of the tax inspectorates along functional lines. A second major accomplishment was the realization by the Government that the system, which rewarded tax collectors with a share of tax fines and penalties, distorted incentives and rewarded corruption. A new tax administration bill was passed which eliminates the collection-incentive payments.

- **Treasury:** USAID technical assistance helped to establish the core of a treasury operation within the Ministry of Finance, which helped consolidate funding control. A cash management system has been established, linking short-term cash availability with public sector treasury bill operations. After the revenue shocks in 1996, the cash management system helped the Government avoid the buildup of wage, pension and other public expenditure arrears which have badly undermined confidence in fiscal policy in other Eastern European countries. Due to these efforts, Lithuania has also been able to secure a near-investment grade credit rating from two international rating services. This has helped the country improve access to international capital markets. Also recommendations to the Ministry of Finance on expenditure management priorities during the revenue collapse in early 1996, alleviated what could have developed into a financial panic.

USAID helped establish a market in treasury securities and assisted in building confidence in the domestic securities market. Weekly cash projections were established. This was a major improvement since until two years ago there was no cash forecasting.

- **Budget Policy:** Our program initiated reforms to: 1) strengthen the legal framework for public expenditures, 2) redesign budget planning and development procedures, 3) eliminate off-budget funding and expenditures, and 4) improve budget monitoring and evaluation. With USAID assistance, the Government adopted program and performance-based budgeting as the country's official policy in 1999. The program also helped the Ministry of Finance in its efforts to consolidate the budget and phase out off-budget expenditures. In addition, a new program and performance-based budget manual, called "Preparation, Submission, Analysis and Evaluation of the National Budget," was designed which helped ensure standardization of the process throughout all the Ministries.

- **Policy Studies:** Three special studies have been prepared to assist in fiscal policy formulation at the Ministry of Finance. Those studies have helped to build strong links between the Ministry of Finance and local Lithuanian research institutions. Also, the studies have helped the Ministry of Finance to analyze issues that are fundamental to fiscal policy decision making. The first study was "Determinants to Economic Growth", the second "Effectiveness and Efficiency of Public Expenditures in the Education Sector" and the third "New Spending Priorities in Education Sector". The study on growth determinants

revealed that almost all of Lithuania's economic rebound originated from the small and medium enterprise sector. The study pointed out that Government's fiscal policy had imposed a rather heavy burden on that sector, while providing support to large companies (both public and private) that were contributing little to growth. It advocated a number of changes in tax, public expenditure and regulatory policies to enhance the business environment for small and medium enterprises. Education is the single largest category of public expenditure. The study on the education sector revealed a host of regional and topical imbalances in education spending and performance. A special study on business and computer education undertaken as a follow-up measure to the first policy study helped define a roadmap to increasing the relevance of the education system to needs of the market economy.

- **Institution Building:** USAID assistance helped augment the Ministry's capacity to manage its own affairs. The combination of on-the-job training and development of an in-service training program for the Ministry made a significant contribution to its human resource capacity. After several years of concentrating on overseas training for Ministry of Finance staff, USAID shifted to in-country training to deepen staff development. Starting in 1999, USAID training resources were focused on the creation of a routine in-service training capacity in public finance, fiscal policy, debt and treasury management, and budget policy.

- **"Lithuania: From Transition to Convergence" Conference:** In September 1999, USAID hosted a conference titled, "Lithuania: From Transition to Convergence," that examined the progress made in economic and democratic reform and helped define the challenges and strategies for the Government to follow in the next decade. The conference inspired an improved and better-informed policy making process, as the Government contends with the challenges posed by economic transition and convergence (i.e., membership in the EU). This was accomplished by generating high-quality analysis and debate on Lithuania's achievements during the economic and democratic transition, future challenges to convergence, and policy reform options. Also, the conference helped to open-up the process of economic policy reform and development strategy debate by inviting researchers and other specialists from a range of government and non-governmental institutions to share their analysis and conclusions with Lithuania's national leaders. Finally, the conference helped to enrich the domestic policy debate by providing opportunities for a mix of international experts to share the results of their research on matters likely to affect Lithuania.

For Lithuania, fiscal policy is the single most important instrument that the Government has at its disposal for influencing economic development. During the transition, the Government has not yet been able to forge a solid link between fiscal policy and a national development strategy, because of the need to transform the economy into a market-based system while stabilizing financial system. With USAID assistance, the Ministry of Finance has been able to play a more active role in ensuring that economic policies are appropriate, that the fiscal strategy is linked to clear development objectives, and that the Government's external and domestic borrowing strategy is sustainable and serves to encourage private investment.

■ The Conference "Lithuania: From Transition to Convergence", September 1999

■ Fiscal Policy Workshop for Ministry of Finance officials in Druskininkai, March 2000

■ A Lithuanian delegation visits the Cash Room at the U.S. Treasury in Washington, D.C.

